EgonZehnder

Synthesis

Governance in the COVID-19 crisis

Like everyone and everything else, boards have had to adapt to a changed world in so many ways. We have conducted over forty different ‘community calls’ with groups of several hundred chairs and board members around the globe over recent months. In them, a number of common themes appear about how boards are responding to the unfolding crisis.

Improving liquidity

Cash has become the key measure. With uncertainty about the future, companies seek to keep cash on hand. In almost every company, the board has acted to ensure the company has drawn down all open credit facilities. Equity raises are also common, with boards noting that in general, shareholders are much more open to providing funding than during the global financial crisis. And in an operating sense, every business is being managed for cash. Major (and minor) capital expenditure has been deferred.

One bit of good news: The virtue of parsimony is evident. Companies have identified and eliminated costs without any impact on productivity, costs they would not have identified otherwise.

For now, the cost of holding cash on hand is very low. But companies in high growth economies like Greater China are being forced to answer the $64 million question: How do we balance protecting cash flow now against investing for the future as the economy recovers?

Strategy

Directors are asking questions such as: *"What is our forecast?" "How will consumer behaviour change?" "How will we be disrupted?"* There is more uncertainty about the future today, but the board of every company still needs to make strategic decisions. *How big should my retail presence be? Should I consider changing my staffing levels? Are we seeing a disruption to our business model that means we will never return to what once was our presence and our route-to-market?*

Everyone wants to know what the board thinks. There is pressure on them to form a view and to communicate it. Many directors talked about the shape of the recovery curve, and different curves in different industries and geographies. Sometimes there are debates between management and the board about those topics, which can be challenging as there are no obvious 'right answers'. In general, management seems to be more optimistic now, while boards are more open to negative outcomes and have slowed down decision making when they feel management has gone too far. But there are also examples of boards giving management a vote of confidence by encouraging them to take risks and make decisions now rather than waiting for clarity that may not come.

Despite the pressure to form a view or communicate one, many participants have warned about making public statements that are too specific when in reality the future is unknown. Spurious certainty is cold comfort. Some boards try not to estimate but lay out what they know, what they would need to know to make decisions, and how to defer the decisions until the unknowns are known. Some other boards are focusing on their own dynamic; being wary of groupthink, seeking and elevating discordant voices and benefiting from having directors who had gone through a crisis during their executive tenures. Overall, the boards doing best are the ones having the most challenging conversations in the boardroom. *"Don't be too comfortable,"* as one participant said.

Operating remotely

The board has quickly learned to operate effectively remotely. Many acknowledge it is different. One director put it well: "*We are now in different time zones, so some people are more present than others. As well, I have to be more decisive about how and when I make my point. Largely I feel I will only get one shot now, so I have to make it count.*"

With the Chair acting as a filter between the board and the executive team by collecting questions and suggestions on how and what to communicate, the board is meeting more often. Especially at the outset of the crisis, we saw boards diving more into operational details than the usual advising and coaching management through the crisis. Boards have been a sounding board for CEOs even more than before.

However, some wonder if the board has become too operational. Are they at risk of overstepping the mark? "We need to keep noses in, hands out, and not the other way around," said one director. More broadly, during a very busy time for executives, it can be both difficult and distracting to face persistent engagement from the board. Some boards have taken the hint, acknowledged the distortion and have adopted some practical resolutions. One example: adding "no need to reply" at the end of emails to the management when previously any email from the board demanded a researched and checked response. The Chair as 'air traffic controller' has a more important role than ever in balancing the interactions between board members and executives.

Reputation

Major companies will need to think about the reputational elements of their recovery plans as the national mood is going to be different when we come out of the pandemic. Should we lay people off when their prospects of other employment are so low? Should we accept government subsidies to assist our financial position?

At stake is the question of a company's role in society. Again, the answer is unclear. The best boards play a role in ensuring that companies have a clear view on that role and act accordingly. They may be judged on their decision, but by which 'jury' and 'when'? For example, we have seen most (now virtual) Annual General Meetings happen quickly and with few questions. But more recently there has been evidence of greater shareholder dissonance, and most boards expect more of that in the year to come.

One permanent result may be that boards must think beyond their direct shareholders and more broadly about the public, society, and how their roles have changed as a result of the crisis. Good boards are reflecting on the big questions, including why their company has a licence to operate in society.

Audit

Audit committees have been in the eye of the storm in recent weeks. Meetings have multiplied as they have been grappling with technical accounting topics, which have the potential to affect the future viability of the business. With no clear blueprint to follow, audit committees have had intense discussions with their auditors on many topics, including how to approach the whole going concern issue, valuing illiquid assets such as real estate, setting triggers for asset impairment and the level of bad debt provisions plus many other subjects! It has been difficult for audit firms and regulators to move as quickly as the crisis has unfolded. It now feels like a more pragmatic approach is being taken, with companies being encouraged to provide scenarios for different outcomes and more rather than less disclosure to allow shareholders to form a better understanding of how they are faring.

Risk

Investors are asking for more transparency in assessing the risk implications of the crisis. No surprise there! But with such uncertainty, what should boards do?

Many are leaning towards more transparency and allowing investors to shape their own views based on these inputs. Some are offering performance data without giving guidance. This empowers both businesses and investors, and encourages both sides to take accountability: Companies disclosing what they feel confident in, and investors being able to interpret that data and synthesise a recommendation from it.

Another consideration around risk is the timeline and the uncertainty of how long the "off-normal" will continue – and even if normal as we once knew it will return. As a result, transparency on estimates and ranges will be important from the governance perspective, as well as for regulators. Many stock exchanges have offered some relief to boards by not expecting them to forecast in the current environment.

Remuneration

There are challenges in setting senior executive remuneration for 2020. Many boards decided to maintain compensation linked to their executives' 2019 performance, although there has been criticism of this, especially for companies that took other actions like furloughing workers or cutting dividends. The timing of companies' fiscal years meant that this became a bigger topic for companies closing their books after the crisis had hit.

The open question is what we do about 2020 and onwards. Some companies have benefited greatly from the crisis, and the relative outperformance is substantial. But how much of that is a credit to the executives concerned? The same goes for the downside: To what extent does the board choose to penalize management for the performance as a consequence of the crisis, at a time where leaders may have worked harder than ever before? It is very challenging to work out the quantitative framework to end up with a fair outcome. Some boards are turning to a mix of financial and non-financial metrics to better balance remuneration outcomes. Companies may also choose to link bonuses and long term incentives to relative performance. Some are also choosing to provide a baseline for long-term incentive achievement to retain talent, conscious that so many legacy plans are deeply out of the money. There is a lively debate between executives and remuneration committees about whether to make new LTI share awards now, at share prices that are deeply discounted, or wait until some future date once share prices have returned "to normal."

There is also a rising ethical component to remuneration. Given the major economic impact of the pandemic, it will undergo more public scrutiny, which will only add to the difficulty of determining remuneration at both executive and board director level. Even the bonus, for example, is justifiable from a governance perspective, but how is it viewed by the wider society – not just by investors? Companies are actively looking at cash alternatives such as work flexibility, leave provisions and so on to reward employees for their work, to ensure executives are not attacked for the level of compensation.

Dividends

Opinions are divided on the best approach toward dividends. Some directors plan to postpone or scrap them amid a rush to preserve resources. On the other hand, there is also an ethical question as to whether it is appropriate to withhold dividends if they have already been declared. Others argue that cancelling dividends will have adverse effects and may trigger share sell-offs. Shareholders and pension funds that rely on dividend payouts may struggle or default, leading to an extreme financial crisis further down the track.

Takeovers and consolidation

When companies emerge from the crisis, it is likely that the landscape will be very different. For those who come out stronger, there will be consolidation opportunities to consider. A company may turn aggressor in order to consolidate or "rescue" a competitor that is failing. However, for those who suffered, their shareholders will undoubtedly ask about survival strategies and how to defend against a hostile takeover. It is also possible that companies risking a hostile bid may seek to take themselves private instead. Private equity intervention is likely in the medium term, considering the war chest available. We have now begun to see some early moves by private equity funds to deploy capital by taking stakes in listed companies. In any case, more transparent communication from the board to shareholders will become critical.

In the near-term, the deal market is closed for now, perhaps with the exception of Asian private equity firms with a China focus. Financing has become a challenge as banks' appetite to finance acquisitions is at a low. Moreover, it is very difficult to carry out any meaningful due diligence. Last but not least, it is difficult to arrive at a sensible valuation, in particular given that the value of equities is so uncertain. There is general agreement that the M&A market has slowed down, and that private equity firms themselves are more focused on improving the performance of their current portfolio companies rather than thinking about potential new acquisitions.

Best practice boards are focused on this question. Many have worked with management to allocate these questions to a small group of highly talented executives, ready to advise the board as required. What is clear, is that deal activity will return. Consolidation will happen. Those with the largest war chests have the luxury of choice.

Who is my CEO?

Many directors commented that they had never learned as much about their own Chief Executives as they had in the last few months. Not all of what they learned was good, but they have had an opportunity to see their senior executive teams in crisis, which will undoubtedly help them think through what the future leadership teams might look like.

Boards are also connecting with their Chief Executives, offering them support with any feelings of loneliness and anxiety, as well as guiding them to think innovatively about keeping people motivated. The CEO is being watched more closely than ever: Those passing the exam can expect total support.

Others have found this all too hard. The road ahead is rocky and steep, and some will be asking themselves whether they have the wherewithal to go on. Boards will need to motivate CEOs as well: CEOs with less than 100% commitment are not welcome!

We are also hearing from boards about a rising alertness to signs of stress and mental health issues amongst senior executives, and how to give more focus to well-being and providing support to leadership teams who have now endured many weeks of intense work, with no letup in sight.

Final words: Adapting to a new world

If we have learned anything during this time, it is that change is inevitable and unstoppable, and it is taking place in a broad range of fundamentally important areas: Liquidity, strategy, operations, risk, remuneration, dividends, takeovers and consolidation, and leadership. Each has financial, human, ethical and reputational implications. We have not even touched on issues such as supply chain restructuring, digital transformation, change in consumer behaviours, and the consolidation of real estate footprints, just to name a few. As companies are reshaping for the new normal, so are boards. In our lifetimes, it's never been a more exciting and more terrifying time to be a director. We are all, as the Chinese proverb says, "crossing the river by feeling our way over the stones."

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Covid-19 Micro-Website

We have launched a micro-website where this and other informative pieces are posted. This site will be regularly updated: click here for further details.

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